

**Before the
Federal Communications Commission
Washington, D.C. 20554**

1993 Annual Access
Tariff Filings

1994 Annual Access
Tariff Filings

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CC Docket No. 93-193

CC Docket No. 94-65

REPLY COMMENTS OF AT&T CORP.

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Pursuant to the Commission's *Notice*,¹ AT&T Corp. ("AT&T") files these reply comments demonstrating that certain price cap local exchange carriers' ("LECs") 1993 and 1994 tariffs reflected rates based upon unlawful return calculations, and that the suspended rates should, accordingly, be declared unlawful and refunds should be required.

INTRODUCTION AND SUMMARY

As the LECs effectively acknowledge, the Commission has already considered the question of how a price cap carrier is to calculate its earnings for purposes of determining its sharing or low-end adjustments for the following year, and it has established that the only reasonable and correct way of doing so is to apply the add-back principle (*i.e.*, to "add back" the sharing or low-end adjustment amounts from the current year). The D.C. Circuit has affirmed that holding. Moreover, the Commission suspended these LECs' 1993 and 1994 tariffs, set an

¹ *Further Comment Requested on the Appropriate Treatment of Sharing and Low-End Adjustments Made by Price Cap Local Exchange Carriers in Filing 1993 and 1994 Interstate Access Tariffs*, CC Docket Nos. 93-193, 94-65, DA 03-1101 (rel. April 7, 2003).

accounting (to keep track of potential refunds), and initiated an investigation for the *purpose* of determining the appropriate application of add-back to these tariffs. Accordingly, the Commission's remaining task is simple: to resolve these pending 1993 and 1994 tariff investigations in a manner consistent with its analysis in all other proceedings involving add-back – *i.e.*, by requiring all of the LECs to apply add-back to all of their 1993 and 1994 tariffs and by ordering refunds to the extent that any particular LECs failed to comply with those principles.

The LECs offer a smattering of baseless arguments to avoid this result. The LECs' principal claim is procedural – that the Commission's hands are tied because application of add-back here would constitute unlawful retroactive rulemaking, and that prior to 1995 add-back was neither required nor prohibited. But the LECs fundamentally misconceive the nature of these proceedings. The Commission need not apply its 1995 add-back rule retroactively; these tariff investigations are themselves rulemakings, and the Commission is fully authorized to establish a rule “of particular applicability” to these tariffs in these investigations. Indeed, the Commission suspended all of the LECs' tariffs – those that applied add-back and those that did not – precisely because its stated purpose in these proceedings was to consider and adopt a consistent rule to be applied to all of these tariffs. And, clearly, that rule should be the across-the-board application of add-back; indeed, the Commission is obligated to adopt a rule here consistent with its later findings in the separate 1995 rulemaking.

On the merits Verizon and SBC now find themselves trying to press the most untenable argument of all: that the Commission should establish a rule here that each LEC may simply choose for itself whether or not to apply add-back, depending on its financial interest. In their 1993 and 1994 tariffs, each LEC applied add-back in a manner that maximized that LEC's

interstate access rates. Accordingly, NYNEX and SNET, which had taken low-end adjustments, applied add-back; other LECs, including Bell Atlantic and Ameritech, had incurred sharing obligations and thus did not apply add-back. But *all* of the LECs agreed that the rule had to be the consistent application of either add-back or no add-back, because there is no rational or non-arbitrary basis for allowing carriers to pick and choose which rule they want and when they wish to apply it. Yet that is exactly the rule that Verizon (which owns both Bell Atlantic and NYNEX) and SBC (which owns Ameritech and SNET) now seek.

The Commission has definitively established, however, that add-back is the only reasonable and correct method of calculating a carrier's sharing and low-end adjustments. Therefore, any rule here that would permit a carrier not to apply add-back – whether it be an across-the-board no-add-back rule or a “pick and choose” rule that would allow carriers not to apply add-back in some circumstances – is indefensible. Verizon and SBC's attempts to portray the failure to apply add-back as a reasonable alternative on the merits are makeweights that have been resoundingly rejected by both the Commission and the D.C. Circuit. And there is *no* reasonable basis whatsoever for a rule that would permit carriers to apply add-back when a company has taken a low-end adjustment but not when it has incurred a sharing obligation.

Finally, unable to defend their tariffs on the merits, the LECs urge the Commission to simply terminate these tariff investigations, without resolving any of the issues set for investigation. The LECs argue that Section 204(a)(2)(B) requires the Commission to issue an order concluding a tariff investigation within twelve months after the rates become effective, and since that twelve months has elapsed here, the Commission has no authority to continue the investigation. But neither the Commission nor the courts have ever endorsed such a view. On the contrary, courts routinely treat Commission failure to act under Section 204 as grounds for a

writ of mandamus, not as grounds for providing the LECs a windfall. Indeed, the LECs' reading of the Act turns the statute on its head. Section 204(a)(2)(A) was enacted for the benefit of *petitioners*, so that their claims would not sit pending for months or years due to Commission inaction. It was not designed to penalize petitioners, and reward LECs charging unlawful rates, if the *Commission* failed to act within the specified time period.

ARGUMENT

I. THE COMMISSION HAS AMPLE AUTHORITY TO REQUIRE LECs TO APPLY ADD-BACK TO THEIR 1993 AND 1994 TARIFFS, AND TO ORDER REFUNDS.

As noted, the substantive merits of these issues are no longer subject to serious dispute. Application of the add-back principle is the only reasonable and correct approach to calculating earnings for purposes of determining the following year's sharing or low-end adjustment obligations. The Commission explained in detail why that is the only reasonable conclusion in the *Add-Back Order*, and has found that add-back is a necessary and implicit part of the price cap system.² Accordingly, the Commission should apply that principle here as well, and require the LECs that failed to comply with the add-back principle in their 1993 and 1994 interstate access tariffs to refund to ratepayers the over-earnings resulting from that unlawful conduct.

The LECs struggle to avoid this conclusion by trying to confuse the nature of these proceedings. They claim that if the Commission reaches the same result in these tariff investigations as it did in the 1995 rulemaking, that such a result would somehow constitute

² Report and Order, *Price Cap Regulation of Local Exchange Carriers; Rate of Return and Lower Formula Adjustment*, 10 FCC Rcd. 5656, ¶ 32 (1995) ("*Add-Back Order*"); *Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195, 1202 (D.C. Cir. 1996) (citing the Commission's conclusion that the "add-back rule had been implicit in the sharing rules from the beginning [of the price cap mechanism]").

retroactive rulemaking (*i.e.*, applying the 1995 rules retroactively), and that the Commission is limited to asking only what a LEC might reasonably have believed to be a sound rule and must allow the LECs to invent and apply whatever standard the LECs deem fitting.³ The LECs' arguments do not withstand scrutiny.

The LECs fundamentally misconceive the nature and purpose of these tariff proceedings. A tariff investigation is itself a “rulemaking[] of particular applicability,” and the Commission is fully authorized to fashion rules that will apply to the tariffs at issue and to order refunds consistent with those findings.⁴ While the 1995 rulemaking established general rules that applied to all tariffs filed in 1995 and afterward, this tariff investigation is a “rulemaking of particular applicability” that will determine the rule to govern these 1993 and 1994 tariffs. And although the 1995 rules do not apply of their own force to these tariffs, the Commission's extensive analysis of the merits of the issues in the *Add-Back Order* is undeniably relevant – indeed, dispositive – of what the rule should be for the tariffs at issue. The Commission should require the LECs to apply the add-back principle, and such a rule adopted in this tariff investigation would not be retroactive.⁵

³ See *BellSouth* at 8-12; *SBC* at 8-10; *Verizon* at 11-12.

⁴ Memorandum Opinion and Order, *Implementation of Special Access Tariffs of Local Exchange Carriers*, 5 FCC Rcd. 4861, ¶ 7 (1990) (“*1990 Tariff Order*”). As demonstrated by AT&T in its initial comments (at 17-18), it would indeed be absurd if the Commission lacked authority to order refunds based on clarifications of existing rules (or even new rules) developed in ongoing tariff investigations. The opposite rule – *i.e.*, that the Commission could not order refunds – would establish an entirely one-sided system that would unlawfully and systematically favor LECs. The LECs would be able immediately and unreasonably to incorporate all slightly ambiguous interstate access rules in a manner favorable to them – as they have done here – while ignoring all ambiguities that are unfavorable to them, to the systematic detriment of ratepayers.

⁵ The Act expressly authorizes the Commission to suspend tariffs, institute an accounting (to keep track of potential refunds), to investigate the suspended tariffs, and to order refunds if the Commission determines that the tariffs are unlawful. 47 U.S.C. § 204. Here, the Commission (continued...)

Indeed, that is precisely what the Commission indicated that it would do when it suspended these tariffs. The Commission made clear in its orders suspending these tariffs that its entire purpose was to consider and adopt a consistent rule and to apply that rule to *these tariffs*.⁶ That is why the Commission suspended all of the LECs' tariffs, including those that applied add-back and those that did not. Accordingly, the purpose of this proceeding is not, as the LECs claim, to determine whether the LECs could have reasonably interpreted the Commission's rules one way or the other in 1993 and 1994,⁷ but to affirmatively establish an appropriate add-back rule for 1993 and 1994 and to require LECs to comply with that rule.

And, as the Commission has consistently determined, the only appropriate rule is add-back – not whatever the LECs' deemed appropriate in 1993 and 1994. If anything, the Commission's substantive inquiry in this proceeding has been made easy by the fact that the Commission has already thoroughly considered the merits of the issue and rendered a detailed explanation of why add-back is correct, which has been upheld by the D.C. Circuit. The Commission has correctly concluded that mandatory application of add-back is “necessary to

properly exercised its authority to suspend the LECs' 1993 and 1994 tariffs, instituted an accounting, and ordered an investigation to determine whether those tariffs properly reflect add-back. Therefore, pursuant to this ongoing investigation of the LECs' 1993 and 1994 tariffs, the Commission has ample authority to determine the appropriate add-back rules for the tariffs under investigation, and to require LECs that failed to comply with those rules to pay refunds. *See also 1990 Tariff Order* ¶ 7.

⁶ *See, e.g.,* Memorandum Opinion And Order Suspending Rates And Designating Issues For Investigation, *1993 Annual Access Tariff Filings; National Exchange Carrier Association Universal Service Fund Lifeline Assistance Rates (Transmittal No. 556); GSF Order Compliance Filings; Bell Operating Companies' Tariff for the 800 Service Management System and 800 Data Base Access Tariffs*, CC Docket Nos. 93-193, 93-123, 93-129; DA 93-762, ¶ 32 (rel. June 23, 1993) (“*1993 Suspension Order*”) (“Because the [add-back] issue is unresolved we suspend the affected tariffs for one day, impose an accounting order, and initiate an investigation pertaining to all LECs that had a sharing amount or low-end adjustment last year.”).

⁷ *See, e.g.,* Verizon at 7-11, 13-14; SBC at 4-8.

achieve fully the purpose of the sharing and low-end adjustment mechanisms,”⁸ and that “[w]ithout [add-back] . . . the sharing and low-end adjustments would not operate as intended.”⁹ And the D.C. Circuit has agreed that the “add-back rule had been implicit in the sharing rules from the beginning [of the price cap mechanism].”¹⁰ Accordingly, any contrary conclusion here would be wholly arbitrary and capricious.¹¹

II. INCONSISTENT APPLICATION OF ADD-BACK IS UNLAWFUL.

Although add-back clearly should be applied across the board, Verizon and SBC are now pressing the most untenable position of all: that the Commission should adopt a rule for these tariffs that permits each LEC to decide for itself which rule to apply, consistent with its financial interests. This is a stark turnabout from all previous pleadings in these proceedings. In 1993 and 1994, *all* parties agreed that add-back always applied or it never applied, and that add-back, if required, must be applied both when LECs reported low-end adjustments and when LECs were

⁸ *Add-Back Order* ¶ 50; *see also id.* ¶ 56 (“the add-back adjustment is essential if the sharing and low-end adjustments of the LEC price cap plan are to achieve their intended purpose”).

⁹ *Id.* ¶ 50.

¹⁰ *Bell Atlantic*, 79 F.3d at 1202 (citing the Commission’s conclusion that the “add-back rule had been implicit in the sharing rules from the beginning [of the price cap mechanism]”).

¹¹ *See, e.g., Motor Vehicle Mfrs Ass’n. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 42 (1983) (when an agency changes a settled policy or course of behavior it “is obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance”). Qwest alone takes the far more extreme position that the Commission affirmatively decided in the *Add-Back Order* that add-back would not be applied to the 1993 and 1994 tariffs. *See* Qwest at 2-9. Qwest’s claim, however, is refuted by the plain terms of the *Add-Back Order* (n. 3), in which the Commission made clear that “[w]e do not decide in this rulemaking whether an add-back adjustment is required for the 1993 and 1994 Annual Access Tariff Filings.” Thus, although the Commission held that its 1995 rule could be applied only prospectively, the Commission expressly recognized in the *Add-Back Order* that the prospective nature of that rule would not legally or logically preclude application of add-back in these tariff investigations.

subject to sharing obligations.¹² The carriers that favored add-back argued that it should be mandatory for all LECs in all circumstances, and the LECs that favored no add-back argued that no LEC should apply it under any circumstances. In the intervening years, however, some of the LECs that applied add-back in their 1993 and 1994 tariffs have merged with LECs that did not apply add-back. As a result, those merged companies (Verizon and SBC), in an attempt to avoid certain refunds, now find themselves arguing that carriers could choose to apply add-back or not prior to 1995, depending on whether it resulted in higher interstate access rates. There is no rational or non-arbitrary basis for such a conclusion.

As a preliminary matter, the purpose of the add-back requirements – to ensure accurate computations of interstate access rates – can be served only if they are applied consistently for all LECs. An optional add-back rule, or an add-back rule that applies only to LECs with prior period low-end adjustment obligations, serves no legitimate purpose. It only allows LECs artificially to inflate their interstate access rates. And, as demonstrated by AT&T (at 21), this arbitrary application of the add-back rules would plainly violate the Communications Act, which prohibits “unjust and unreasonable” rates.¹³

¹² Ameritech 1993 Reply at 3 (CC Docket No. 93-179, filed Sept. 1, 1993) (explaining that add-back for “both sharing and [low-end adjustments must] be treated the same”); BellSouth 1993 Reply at 12 (CC Docket No. 93-179, filed Sept. 1, 1993) (“[t]he Commission clearly intended that the two backstop mechanisms, sharing and lower formula adjustment, operate symmetrically”); Bell Atlantic 1993 Reply at 4 (CC Docket No. 93-179, filed Sept. 1, 1993) (a “one-sided” mechanism would “ignore[] the theoretical underpinnings of the [sharing and low-end adjustment mechanisms]”); GTE 1993 Reply at 11 (CC Docket No. 93-179, filed Sept. 1, 1993) an “asymmetric” rule would be “unlawful” and would “bear[] no resemblance to the Commission’s balanced plan”). *Accord Add-Back Order* n. 41 (rejecting a “bifurcated” add-back adjustment, noting the LECs’ statements that “both the sharing and low-end adjustment mechanisms were intended to compensate for unanticipated errors in the productivity offset and must be treated identically”).

¹³ 47 U.S.C. § 201(b).

In all events, the Commission has definitively refuted any notion that it is reasonable for any carrier to not apply add-back when computing interstate access rates. The Commission made clear in the *1990 Price Cap Order* that it intended the sharing and low-end adjustments to “operate only as one-time adjustments to a single year’s rates, so a LEC does not risk affecting future rates.”¹⁴ And, as the Commission demonstrated in the *Add-Back Order*, add-back is necessary to ensure that sharing and low-end adjustments affect only a single year’s rates.¹⁵ The D.C. Circuit agreed that “without add-back, the sharing adjustment . . . would continue to affect a carrier’s price caps year after year because the carrier’s earnings, rather than reflecting the carrier’s true productivity, would simply reflect the previous year’s sharing obligation.”¹⁶

Moreover, using several numerical examples, the Commission demonstrated the *mathematical reality* that, absent add-back, the LECs’ rates over time would not reflect the full amount that the Commission intended the LECs to share with ratepayers under the *1990 Price Cap Order*.¹⁷ Conversely, failure to apply add-back would underestimate the amount the Commission intended the LECs to receive in low-end adjustments, which in extreme cases could render the price cap regime confiscatory. Simply put, as a mathematical proposition, there is no reasonable case to be made for the failure to apply the add-back principle.

Verizon and SBC offer no legitimate response to these facts, but instead rehash arguments that have been expressly discredited by both the Commission and the D.C. Circuit in

¹⁴ Second Report and Order, *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd. 6786 ¶ 42 (1990) (“*1990 Price Cap Order*”).

¹⁵ *Add-Back Order* ¶ 28.

¹⁶ *Bell Atlantic*, 79 F.3d at 1205.

¹⁷ See *Add-Back Order* ¶¶ 18-28.

an attempt to resuscitate no-add-back as a reasonable option. Those arguments, however, are just as meritless today as they were in 1993 and in 1995. For example, Verizon and SBC both reassert the claim that add-back could inappropriately result in a sharing obligation that would not otherwise occur.¹⁸ As the Commission explained, however, this claim “mischaracterizes the cause of the sharing in these circumstances. Sharing does not arise because of an add-back adjustment, but rather because the LEC’s earning levels in each year, once adjusted to remove the effects of a sharing obligation generated by a previous year’s high earnings, remain in the sharing zone.”¹⁹ Verizon and SBC also claim that the Commission could have viewed add-back as effectively turning the price cap system, in which high returns were not necessarily unlawful, into a rate-of-return scheme, but add-back clearly does not limit the LECs’ earnings nor does it function as a refund. As the D.C. Circuit made clear, the sharing mechanism with add-back is purely prospective; “[i]f a carrier went out of business at the end of Year 1 it would face no liability, no matter how high its earnings were that year.”²⁰ The add-back rule “does not change the fundamental nature of the sharing mechanism”; “with or without [add-back], the sharing mechanism is still a prospective adjustment designed to allow customers to share prospectively in the [LEC’s] unanticipated productivity gains.”²¹ Moreover, SBC’s argument (at 7) that earnings would “stabilize” over time essentially concedes that failure to apply add-back leads to incorrect results in the relevant years, but there is no rational basis for choosing an option that

¹⁸ See Verizon at 9; SBC at 7 & n.7.

¹⁹ *Add-Back Order* ¶ 35; see also *Bell Atlantic*, 79 F.3d at 1205-06.

²⁰ *Bell Atlantic*, 79 F.3d at 1207.

²¹ *Id.* at 1206.

indisputably produces incorrect results year after year over the option that produces precisely correct results every year.

Verizon's and SBC's position is more untenable than even these discredited arguments suggest, because what Verizon and SBC really seek is the authority to apply add-back when it would result in higher rates (*i.e.*, to "add back" a low-end adjustment) and not to apply add-back when it would result in lower rates (*i.e.*, "adding back" a sharing adjustment). Although Verizon and SBC now portray the various LECs' differing approaches as the result of abstract philosophical differences about the theory of price cap regulation, in fact the LECs' positions (not surprisingly) tracked closely whether or not their earnings were in the sharing or low-end adjustment ranges. This is the most indefensible position of all, however, because, as *all* parties have recognized until now, there is no material difference between sharing and low-end adjustments that would have any implications for application of the add-back rule. In other words, there is *no* reasonable argument in favor of a rule applying add-back to low-end adjustments and no-add-back to sharing adjustments, and no LEC (including Verizon and SBC here) has ever even attempted to offer any rationale for doing so. Any Commission decision permitting the LECs to choose add-back based solely on whether it was in their financial interest would thus be strikingly arbitrary.

III. THE COMMISSION HAS A LEGAL DUTY TO RESOLVE THE 1993 AND 1994 TARIFF PROCEEDINGS ON THE MERITS.

The LECs assert that Section 204(a)(2)(B) requires the Commission to issue an order concluding a tariff investigation within twelve months after the rates become effective, and since that twelve months has elapsed here, the Commission has no authority to continue the

investigation.²² In effect, under the LECs' reading of the statute, the Commission's failure to act within twelve months operates as a revocation of the suspension and accounting orders and as a decision in the LECs' favor. Neither the Commission nor the courts have ever endorsed such a view.²³ Indeed, courts have routinely treated Commission failure to act under Section 204 not as grounds for dismissing the claim, but as grounds for a writ of mandamus to the Commission or other relief to complete the investigation on the merits.²⁴ The LECs' reading would turn the statute on its head, because Section 204(a)(2)(A) was enacted for the benefit of *petitioners*, so that their claims would not sit pending for months or years due to Commission inaction. Contrary to statutory intent, the LECs would unfairly and perversely penalize petitioners, and reward carriers charging unlawful rates, all because of the *Commission's* failure to act.

Lacking a legitimate legal argument, Verizon claims that it would be inequitable for the Commission to issue refunds for unlawful behavior that occurred 10 years ago. Verizon asserts that the Commission's delay has "prejudiced Verizon's ability to defend its tariffs."²⁵ As an initial matter, the issues in this proceeding are primarily legal issues – whether the Commission should require all carriers to apply add-back to their 1993 and 1994 tariffs. Verizon is in no way

²² See BellSouth at 2-8; SBC at 4; Verizon at 14-15.

²³ Verizon (at 15-16) cites to *Illinois Bell Tel. Co. v. FCC*, 966 F.2d 1478 (D.C. Cir. 1992), but the court there held only that the Commission could not order refunds under Section 204 unless it had issued a suspension order. The court had no occasion to address the effect of Section 204(a)(2)(B).

²⁴ See, e.g., *Telecommunications Research and Action Center v. FCC*, 750 F.2d 70, 75-79 (D.C. Cir. 1984); *MCI Telecommunications Corp. v. FCC*, 627 F.2d 322, 340 (D.C. Cir. 1980); see also 134 Cong. Rec. H10,454 (daily ed. Oct. 19, 1988) (statement of Sen. Inouye) ("We expect that the FCC will comply with the time deadlines [in § 204] . . . and that the Court of Appeals for the D.C. Circuit will grant petitions for mandamus in short order should the FCC fail to comply").

²⁵ Verizon at 17.

(continued...)

prejudiced in responding to such legal issues. In any event, Verizon was fully aware that its 1993 and 1994 tariffs were under investigation and that Verizon may be subject to refunds and therefore was on notice that it should maintain all necessary records relating to those tariff investigations. If Verizon failed to do so, ratepayers that were subject to Verizon's inflated rates should not be left holding the bag. Indeed, Verizon is hardly in a position to argue that the equities favor a Commission termination of this proceeding without a decision on the merits. As demonstrated in AT&T's initial Comments, the LECs' unlawful tariffs permitted them to over-recover from ratepayers between \$37.5 and over \$55 million dollars, and the LECs have enjoyed the use of those unlawful earnings for the past ten years. By contrast, AT&T and other ratepayers have effectively floated a \$37.5 to \$55 million dollar loan to the LECs over the past 10 years. The equities here plainly lie in returning those funds to ratepayers, not in arbitrarily terminating the add-back proceedings.²⁶

²⁶ Verizon's claim (at 17) that, to the extent AT&T receives any LEC refunds, AT&T "would have to refund most of [any refunds received by AT&T from the LECs] . . . to its own customers for these periods, since AT&T incorporated the local exchange carriers' exogenous cost increases . . . in its own 1993 tariff filing" is frivolous. In fact, AT&T's tariffs did not explicitly correct for the LECs' unlawful application of add-back. Rather, as the tariff investigation order cited by Verizon makes clear, the only LEC-related exogenous costs explicitly incorporated by AT&T were those associated with the LECs' unlawful accounting treatment of "other employee pension and benefits." *AT&T Communications, Tariff Nos. 1 and 2, Transmittal Nos. 5460, 5461 and 5464*, 8 FCC Rcd. 6227, ¶ 3 (1993). And, the only portion of AT&T's tariffs that were suspended by the Commission were the portions reflecting the increased costs that resulted from the LECs accounting treatment of OPEBs. *Id.*

CONCLUSION

For the foregoing reasons, and for the reasons stated in AT&T's initial comments, the Commission should find unlawful the 1993 and 1994 tariffs of LECs that failed to apply add-back and require those LECs to make refunds. Alternatively, the Commission should find unlawful the 1993 and 1994 tariffs of LECs (NYNEX and SNET) that applied add-back and require those LECs to make refunds.

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the foregoing Reply Comments of AT&T Corp. was served, by the noted methods, the 19th day of May, 2003, on the following:

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